Nos. 20,117, 20,118 and 20,119

IN THE

United States Court of Appeals

For the Ninth Circuit

MADE RITE INVESTMENT CO., *Petitioner*, vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	No. 20,117
MADE RITE TRANSPORTATION CO., *Petitioner*, vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	No. 20,118
MADE RITE MANUFACTURING CO., *Petitioner*, vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	No. 20,119

BRIEF FOR PETITIONERS

WAYNE HEA,
HEA AND ANDERSON,
25 Taylor Street,
San Francisco 2, California,
Attorneys for Petitioners.

PERNAU-WALSH PRINTING CO., SAN FRANCISCO

Subject Index

Table of Authorities Cited

Cases

Codes

Regulations

Texts

Nos. 20,117, 20,118, 20,119

IN THE

United States Court of Appeals

For the Ninth Circuit

MADE RITE INVESTMENT CO., *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 20,117
MADE RITE TRANSPORTATION CO., *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 20,118
MADE RITE MANUFACTURING CO., *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 20,119

BRIEF FOR PETITIONERS

This is an appeal from three decisions of the Tax Court of the United States rendered on January 21, 1965, and reported at 41 T.C. No. 75.

JURISDICTION

Made Rite Investment Co.

The appeal of petitioner, Made Rite Investment Co., (hereinafter called Investment), involves Federal income taxes for the calendar years 1956, 1957, 1958 and 1959. On September 27, 1961, the Commissioner of Internal Revenue mailed to Investment a Notice of Deficiency (R. 11-16). Within ninety days, petitioner, Investment, filed a Petition with the Tax Court of the United States for a redetermination of the deficiency for income taxes (R. 1-65). On February 6, 1962, respondent filed an answer to the petition (R. 66-68). The decision of the Tax Court, determining deficiencies against Investment for the calendar years 1956, 1957, 1958 and 1959 in the respective amounts of $20,072.00, $7,911.55, $5,675.55 and $5,675.55 was entered on January 21, 1965 (R. 269). The case was brought to this Court by a Petition for Review filed April 12, 1965 (R. 287-294), pursuant to Sections 7482 and 7483 of the Internal Revenue Code of 1954. Petitioner's tax returns here involved were filed with the District Director of Internal Revenue at San Francisco, California.

Made Rite Transportation Co.

The appeal of petitioner, Made Rite Transportation Co., (hereinafter called Transportation), involves Federal income taxes for the calendar years 1956, 1957, 1958 and 1959. On September 27, 1961, the Commissioner of Internal Revenue mailed to Transportation a Notice of Deficiency (R. 78-83). Within ninety days, petitioner, Transportation, filed a Peti-

tion with the Tax Court of the United States for a redetermination of the deficiency for income taxes (R. 67-131). On February 6, 1962, respondent filed an answer to the petition (R. 132-133). The decision of the Tax Court, determining deficiencies against Transportation for the calendar years 1956, 1957, 1958 and 1959 in the respective amounts of $17,780.94, $8,732.94, $5,664.95 and $6,879.52 was entered on January 21, 1965 (R. 276). The case was brought to this Court by a Petition for Review filed April 12, 1965 (R. 295-301), pursuant to Sections 7482 and 7483 of the Internal Revenue Code of 1954. Petitioner's tax returns here involved were filed with the District Director of Internal Revenue at San Francisco, California.

Made Rite Manufacturing Co.

The appeal of petitioner, Made Rite Manufacturing Co., (hereinafter called Manufacturing), involves Federal income taxes for the calendar years 1958 and 1959. On September 27, 1961, the Commissioner of Internal Revenue mailed to Manufacturing a Notice of Deficiency (R. 143-147). Within ninety days, petitioner, Manufacturing, filed a Petition with the Tax Court of the United States for a redetermination of the deficiency for income taxes (R. 134-195). On February 6, 1962, respondent filed an answer to the petition (R. 196-197). The decision of the Tax Court wherein said Court determined an overpayment of $3,823.60 to be due the petitioner, Manufacturing, for the year 1958, and wherein the Tax Court determined a deficiency of $6,053.66 to be due from the petitioner,

Manufacturing, for the year 1959, was entered on January 21, 1965 (R. 285-286). The case was brought to this Court by a Petition for Review filed April 12, 1965 (R. 302-307), pursuant to Sections 7482 and 7483 of the Internal Revenue Code of 1954. Petitioner's tax returns here involved were filed with the District Director of Internal Revenue at San Francisco, California.

STATEMENT OF THE CASE

There are two issues involved in this appeal.

1. Was the principal purpose for the organization of the three petitioner corporations, rather than a single corporation, the avoidance of income taxes by securing the benefit of additional surtax exemptions, and were three of the surtax exemptions properly disallowed by the Tax Court under Section 269 of the Internal Revenue Code of 1954.

2. Was the Tax Court correct in its determination of the amounts representing reasonable compensation paid to officers and employees of petitioner Investment during 1956 and 1957 and was the Tax Court correct in its determination of the amounts representing reasonable compensation to one of the officers of petitioner Transportation during 1956 and 1957.

STATEMENT OF FACTS

Commencing about 1930, Dillier and others were engaged in the business of manufacturing, processing and selling frankfurters, luncheon meats and other sausage products, as well as hams and bacon, as a partnership under the name of Made Rite Sausage Company (hereinafter sometimes called the partnership). Between 1930 and 1955 there was a substantial growth in the business of the partnership (R. 214).

Either at the same time that Johnson acquired his interest or at some other undisclosed time prior to 1949, Curnow, Halter and Kaelin each acquired an interest in the partnership equal to that of Johnson. In 1949, Johnson, Curnow, Halter and Kaelin purchased additional interests in the partnership from Dillier, so that thereafter each of the five partners owned an equal one-fifth interest. The partnership was operated under written "Articles of Copartnership" dated February 26, 1949 (R. 215).

After the five individuals became equal partners, their respective duties were as follows: Curnow was in charge of sales; Halter was in charge of production; Kaelin was the meat buyer, and also was in charge of the fresh meat operations and the maintenance of the plant and refrigeration equipment; Johnson was in charge of office and clerical functions, credit and collections, advertising, bookkeeping, purchasing of packaging supplies, and labor relations; and Dillier was the general manager of the entire operation. Commencing about 1955, Dillier took a less

active role in the partnership business, his duties becoming advisory in nature, while Johnson assumed more of the general managerial duties (R. 215).

Thores Johnson, who was in charge of the accounting was first employed by the Made Rite Sausage Co. (a co-partnership) in the year 1930. At that time he was 24 years of age (Tr. 20). At the time of his employment by the partnership, he had had no corporate accounting experience. He was hired initially as a bookkeeper. He later became office manager and then later, in 1942, acquired a partnership interest (Tr. 21).

The main plant and offices of the partnership were located in a building or buildings owned by it at 3353 Second Avenue, Sacramento, California. The city block in which the property was located consisted of 14 or 15 lots. By 1955, the partnership owned nine of the lots and portions of two others (R. 215).

The meat products processed by the partnership were sold under the name "Made Rite Camellia Brand." Sales were made to grocery stores and other retail outlets in the northern two-thirds of California by driver-salesmen employed by the partnership covering regularly assigned routes. The driver-salesmen made sales to their customers directly from the trucks. Small quantities of certain other products, such as cheese, purchased by the partnership from other producers, were also sold by the driver-salesmen. In addition, small amounts of fresh meats were sold directly from the plant.

During the calendar years 1948 through 1954, the net income of the partnership and each partner's share of such income were as follows:

Year	Partnership Net Income	Dillier	Johnson, Halter, Curnow and Kaelin, Each
1948	$244,248.69	$135,693.73	$27,138.74
1949	221,584.00	44,316.80	44,316.80
1950	191,904.00	38,380.80	38,380.80
1951	226,049.46	45,209.89	45,209.89
1952	275,341.90	55,068.38	55,068.38
1953	260,091.05	52,018.21	52,018.21
1954	231,453.96	46,290.79	46,290.79

(R. 216.)

In the mid-Fifties the partners began to realize that they were faced with certain important financial and non-financial problems in connection with their business, the Made Rite Sausage Co. (a co-partnership) (Tr. 23). One of the prime problems was that the Made Rite organization operated in partnership form and such partnership had a very large net worth (Tr. 23). By 1955 the partnership had grown to where it had annual sales of approximately $7,000,000 and employed assets in the partnership business of over $2,000,000. It employed some 200 employees (Tr. 21).

Another problem existing at that time was the advancing age of most of the partners and the possibility of death from among them. Joseph Dillier was approximately 63 years of age, Frank Halter and Clarence Curnow were approximately 56, Fred Kaelin was approximately 55 and Thores Johnson was ap-

proximately 49. The partnership had had two deaths during preceding years and these deaths had caused financial problems to the firm. The financial problems had been lessened to a certain extent because of substantial amounts of insurance then carried on the lives of the decedent partners by the remaining partners. Also the firm was much smaller at that time (Tr. 23). However, from these prior deaths the partners were aware they would have to secure funds, in the case of a partner's death, with which to purchase a decedent's interest in the business and to provide the widows and dependents with money to live on, when such widows and dependents are not producing any income for the firm (Tr. 23).

At this time the partners became aware of how difficult it was to pay off, out of their annual earnings, the promissory notes they individually owed to Joseph Dillier (Tr. 23). These notes the individual petitioners had given to Joseph Dillier as part of the purchase price of their equal partnership interests which they had purchased from Joseph Dillier previously (Tr. 23). These notes also created estate liquidity problems for the debtor partners (Tr. 25). In 1954, when Joseph Dillier saw the vulnerability of the obligations owed by the remaining partners to him, he requested that the remaining four other partners each take out $50,000 principal amount of insurance (a total of $200,000 principal amount of life insurance) on their own lives in order to protect him in connection with the $200,000 debt which they owed him on

the purchase price of their partnership interests which they had acquired from him. In the early part of 1955, the four partners, other than Joseph Dillier, each carried $10,000 of insurance on their lives to protect the four partners as among themselves (Tr. 45). The insurance which Joseph Dillier required the remaining partners to take out in 1954 on their own lives in order to protect him in connection with the $200,000 debt which they owed him on the purchase price of their partnership interest was kept in effect for four years and then, because the corporate arrangement made it possible for the remaining partners to borrow from the bank to pay off the obligation they owed Joseph Dillier, said insurance was cancelled (Tr. 45).

In 1954, Thores Johnson had his own personal estate analyzed to determine methods available to discharge his liability in regard to the promissory notes he owed to Joseph Diller, in the event of Thores Johnson's untimely death (Tr. 25).

Another problem was that in the early 1950's the meat industry was changing from a bulk-type industry to a consumers industry. This latter operation required additional amounts of capital for machinery so as to be able to automate (Tr. 32). Since none of the partners except Joseph Dillier had any independent assets, i.e., assets which they personally owned and not used in the Made Rite operations they were reluctant to have their entire personal fortunes tied up in this one partnership (Tr. 32).

In addition to the above, in the early and mid-Fifties the meat industry was having a difficult time, with many of the local California firms going out of business, (Tr. 38 and Tr. 39), due to increasing competition in California from national meat firms.

Another problem was the fact that one of the partners owed, but was unable to pay, certain financial obligations in regard to his recent divorce (Tr. 37).

While operating in partnership form it became apparent that the matter of expense and other accounting allocations were becoming an increasing problem. This was because the operating heads (who are also partners) of the separate divisions of the business objected to certain expense allocations on the basis that they were merely bookkeeping entries and did not reflect the true results of the operation of his department (Tr. 33).

On or about March 10, 1954, Thores Johnson, on behalf of the other partners and himself, solicited a sale and leaseback arrangement of the plant with the Equitable Life Assurance Company for the purpose of creating a capital fund with which to pay off Joseph Dillier (Tr. 27-28, R. 205). During the year 1956, Thores Johnson continued to seek a sale and leaseback arrangement for the Sacramento meat packing plant, land and building owned by Made Rite Investment Co. (R. 204). During the year 1957, Thores Johnson continued to seek a sale and leaseback arrangement for the Sacramento meat packing plant, land and building, owned by Made Rite Investment

Co. (R. 205). Throughout all the years covered by this tax case, Made Rite Investment Co. has been attempting to sell or sell and lease back the real property (Tr. 190).

In the years 1954 and 1955 Thores Johnson attempted to research and to determine what could be done to solve the above problems. He talked to other business people, discussed it with the partnership's banker and accountant, read material on it and discussed it with other people in the meat packing industry (Tr. 24). Thores Johnson felt that a solution to some of the above problems could be had through the creation of four corporations out of the existing Made Rite partnership. He felt that placing the real estate in one corporation would provide a secured source of fixed income for death or retirement purposes. In addition, the valuable truck fleet could be placed in a second corporation—also to provide a fixed income. He felt that in the event of the death of a partner, it might be possible to have the partners' surviving heirs retain their shares in these two fixed income corporations. Also, it was felt that it might be possible to sell either of these two groups of assets and thus provide a source of funds with which to furnish cash for the needs of a partner's heirs (Tr. 29 and Tr. 30).

In the spring of 1955, Thores Johnson, on behalf of the partners, consulted with their banker, Malland L. Madland, President of the Capitol National Bank of Sacramento, to determine said banker's reaction to Thores Johnson's idea of creating four corporations

out of the partnership. The consultation was necessary because the Made Rite partnership owed the bank money and because future borrowings would likely be made by the new corporations (Tr. 28 and Tr. 29). Malland L. Madland felt that the creation of four corporations was the only practical solution to the problems connected with the possible death of one or more of the partners and the partners' existing indebtedness (Tr. 265 and Tr. 266). On or about August 9, 1955, Malland L. Madland wrote a memo to his head office in regard to the four corporations (Tr. 268).

Prior to incorporation the idea of several corporations was also discussed with an insurance man by the name of Gilbert Schwarz (Tr. 48).

It was felt that splitting the assets up into different corporations would help limit liability in case of adverse financial circumstances. Separate corporations, it was felt would help insulate liability in connection with the large capital investment requirements necessitated by the changeover of the industry from a bulk-type industry to a consumers industry and the large capital investment required by the latter (Tr. 32 and Tr. 39). Also, it was felt that any one or more of the three operations other than sales could be disposed of and the sales organization still continue in business if the competition forced them into that position (Tr. 39 and Tr. 40).

The matter of the four corporations was discussed with the company's accountant shortly after the mat-

ter was discussed with the banker in the early spring of 1955 (Tr. 47).

The matter of the tax implications of the four corporations versus one was taken into consideration in the same manner as any other aspect of the incorporation. Taxes were not a significant factor nor a decisive factor in their decision. The taxpayers had no assurance that the corporations were going to make an income of $25,000 a year. In fact some of them lost money in certain of the years involved in this tax controversy (Tr. 202).

In the middle or the late part of June, 1955, the decision was made to set up four corporations (Tr. 48) and Thores Johnson requested his accountant, William Himmelmann, Jr., to recommend an attorney to handle the incorporation of the four corporations. The accountant, William Himmelmann, Jr., recommended an attorney whom Thores Johnson did not know nor had not met (Tr. 271). Later Thores Johnson asked William Himmelmann, Jr. to contact the recommended attorney and arrange for an appointment. After this contact the attorney went to Sacramento and met with the five partners. There was no consultation with the attorney prior to June, 1955 (Tr. 48). Shortly after that the Articles of Incorporation for the four corporations were filed (Tr. 272).

The three petitioner corporations, and the other related corporation, Made Rite Sausage Co. (herein called Sausage) are corporations organized under the laws of the State of California (R. 213-214).

California corporate franchise tax returns for the years 1956 through 1959 were timely filed on behalf of each of the four Made Rite corporations and the taxes due thereon were timely paid (R. 233).

By a deed executed on May 4, 1961, and recorded on June 1, 1961, Investment acquired from an unrelated person another parcel of real property in the block in which the main plant was located (R. 237).

The Made Rite Transportation Co. has sold all of its transportation equipment and the corporation has been liquidated (Tr. 189). In 1962, the truck fleet was sold and leased back and this corporation liquidated (Tr. 30). Prior to 1955, the partnership attempted to work out a sale and leaseback of the trucks, but found it impractical. Because of the detailed cost figures maintained by the separate transportation corporation, it was possible to work out a satisfactory lease arrangement in 1962 after a trial basis which had started in 1960 (Tr. 30 and Tr. 31).

Certain of the stockholders of the Made Rite corporations have disposed of some of the promissory notes received at the time of incorporation, on a non-pro rata basis, to certain of their relatives; that is, notes were given in one or two of the corporations but not all four (Tr. 247 and Tr. 278).

In connection with the partner who owed certain financial obligations in regard to his divorce settlement, banker Malland L. Madland, President of the Capitol National Bank of Sacramento, had advised that the bank would advance funds on secured notes

on the real property in the real estate corporation in order that among other things, this partner could dispose of some of these notes in payment of said marital obligations (Tr. 37).

The accounting on a separate corporation arm's-length basis has resulted in some of the corporations showing losses, some corporations showing moderate profits and some showing very satisfactory profits, depending upon their actual results of operations (Tr. 34). The net income (or loss) of the Made Rite corporations for the years 1956 through 1959, as shown on the returns filed for those years, was as follows:

	1956	1957	1958	1959
Sausage	$100,401.42	$57,609.51	$ 37,922.00	$ 73,162.91
Manufacturing	39,661.29	(57,757.27)	17,842.62	160,419.10
Investment	18,288.87	55,020.57	54,255.37	31,149.49
Transportation	30,133.25	33,695.23	41,531.81	57,513.89
Totals	$188,484.83	$88,568.04	$151,551.80	$322,245.39

(R. 235.)

The Tax Court held that the principal purpose for the organization of the four Made Rite corporations, rather than a single corporation, and the acquisition by the partners of all of the stock of those corporations was to avoid Federal income tax by securing the benefit of three additional surtax exemptions, which would not otherwise have been available (R. 238).

During the years 1956 through 1959, Dillier, Kaelin, Curnow, Johnson and Halter were paid compensation by the four Made Rite corporations as follows:

1956	Sausage	Manufac-turing	Transpor-tation	Invest-ment	Total
Dillier	$ 2,000	0	$23,800	0	$ 25,800
Kaelin	0	$ 25,800	0	0	25,800
Curnow	25,800	0	0	0	25,800
Johnson	0	0	0	$25,800	25,800
Halter	0	25,800	0	0	25,800
Totals	$27,800	$ 51,600	$23,800	$25,800	$129,000
1957					
Dillier	$ 6,800	$ 6,800	$ 6,400	$ 4,800	$ 24,800
Kaelin	0	24,800	0	0	24,800
Curnow	24,800	0	0	0	24,800
Johnson	9,520	11,520	1,760	1,760	24,560
Halter	0	24,800	0	0	24,800
Totals	$41,120	$ 67,920	$ 8,160	$ 6,560	$123,760
1958					
Dillier	$ 9,240	$ 18,720	$ 400	0	$ 28,360
Kaelin	7,160	21,200	0	0	28,360
Curnow	28,360	0	0	0	28,360
Johnson	13,560	15,120	160	0	28,840
Halter	3,000	25,360	0	0	28,360
Totals	$61,320	$ 80,400	$ 560	0	$142,280
1959					
Dillier	$ 6,240	$ 18,720	0	0	$ 24,960
Kaelin	4,160	30,300	0	0	34,460
Curnow	29,960	4,750	0	0	34,710
Johnson	10,400	24,310	0	0	34,710
Halter	0	34,960	0	0	34,960
Totals	$50,760	$113,040	0	0	$163,800

The amounts so paid were claimed as deductions on the returns filed by the respective corporations (R. 233-234).

On its 1956 and 1957 income tax returns, Investment claimed deductions of $34,009.80 and $6,560, respectively, representing compensation paid as follows:

	1956	1957
Thores Johnson	\$25,800.00	\$1,760.00
Joseph Dillier	—	4,800.00
Geneva Hayhurst	5,238.00	—
Chester Brewster	2,916.80	—
M. Schoenbacker	55.00	—
Totals	\$34,009.80	\$6,560.00

(R. 235. A.).

Geneva Hayhurst had been employed by the partnership in 1941 as a bookkeeper. She had taken a bookkeeping course in high school and had worked as a bookkeeper for another sausage company prior to being employed by the partnership. During 1956 she was the office manager for the four corporations, but received compensation only from Investment. Her duties included supervision of the office services for all four corporations and keeping the books for Sausage and Manufacturing. The bulk of her work was concerned with the business of Sausage, with only a small portion of her time being devoted to the affairs of Investment. The books of Investment and Transportation were kept by another bookkeeper in the office. Investment paid no other office salaries during the years 1956 through 1959, nor did it claim a deduction for any office expenses on its returns for those years. During 1957, 1958 and 1959, Geneva Hayhurst received no compensation from Investment. The record does not indicate which of the other Made Rite corporations paid her salary for those years (R. 236). The salary for Miss Hayhurst was in effect a method

of allocating office costs and bookkeeping costs and office space and machinery and personnel salary. It was felt that if one employee was assigned to this corporation and that employee's salary paid by Made Rite Investment Co. that this salary would be a reimbursement for these above-mentioned expenses of this corporation (Tr. 163).

Chester Brewster had been the night watchman for the partnership and continued to perform the same function after the four corporations took over the business. His duties were to guard the main plant building, title to which was transferred to Investment during 1956, as well as the property belonging to the other Made Rite corporations located on the plant premises, including trucks, title to which was in Transportation, and machinery and inventory, which were listed as belonging to Manufacturing. Schoenbacker acted as night watchman for one week during 1956 while Brewster was on vacation. The amounts paid by Investment during 1956 to Brewster and Schoenbacker were the only amounts paid by any of the Made Rite corporations for the services of night watchmen during that year. During 1957, 1958 and 1959, the night watchmen employed in the Made Rite business received their entire compensation from Manufacturing (R. 236). Made Rite Investment Co. paid Chester Brewster $2,916.80 for services rendered during the year 1956. He was employed as a night watchman, security officer, to guard the plant during the night hours (Tr. 166).

A salary of $23,800.00 was paid to Joseph Dillier by Made Rite Transportation Company for the year 1956 (Tr. 174). Joseph Dillier had driven a truck in this meat operation at the inception of the company for some ten years. He had as a driver of a truck operated a sales route. He was assigned the responsibility in 1956 of the supervision, maintenance, repairs and operation of the truck fleet owned by Made Rite Transportation Company. In addition, he was responsible for the construction of bodies of the trucks and of the buying of new trucks and facilities. He also was to pursue the matter of the sale and leaseback of the entire fleet of trucks (Tr. 174 and Tr. 175). The salary arrangement made with Joseph Dillier for 1956 was a contractual arrangement made by the Board of Directors of Made Rite Transportation Company (Tr. 175 and Tr. 176). In 1957, Joseph Dillier was paid $6,400.00 for services rendered to the Made Rite Transportation Company (Tr. 174). The salary of Joseph Dillier for the year 1957 was reduced based upon experience gained during the year 1956. The salary was reduced to the time and effort which it was anticipated would be put in by Joseph Dillier in 1957 based on the experience of 1956 (Tr. 175).

Thores Johnson, for the year 1956, was paid the sum of $25,800 as compensation for services rendered to Made Rite Investment Co. (Tr. 160). The salary was established on the basis that Thores Johnson would be devoting most of his time to the Investment Company with the idea of endeavoring to secure a

sale of the assets of the Investment Company. Salaries were set on the basis of the expected duties and activities of an executive and what he would be most likely to concern himself with during the ensuing year (Tr. 162). Thores Johnson worked on sale and leaseback arrangements for the plant during the year 1956 (Tr. 179). Thores Johnson devoted substantially all of his time to the Made Rite Corporations (Tr. 197 and Tr. 198). He had some outside interests which he took care of mainly after working hours, weekends and vacation time. During the five preceding years prior to the incorporation of the four corporations, Thores Johnson had earned approximately $40,000 to $60,000 per year (Tr. 169). In 1957, Thores Johnson was paid $1,760.00 for services rendered to Made Rite Transportation Company (Tr. 174). The salary of Thores Johnson for the year 1957 was reduced based upon experience gained during the year 1956. The salary was reduced to the time and effort which it was anticipated would be put in by Thores Johnson in 1957 based on the experience of 1956 (Tr. 175).

The Tax Court held that reasonable compensation for services rendered to Investment by its officers and employees during 1956 was as follows: Thores Johnson, $1,760; Geneva Hayhurst, $500; Chester Brewster, $1,200; M. Schoenbacker, $25. Reasonable compensation for services rendered to Investment by its officers and employees during 1957 was as follows: Thores Johnson, $1,760; Joseph Dillier, $500; and that reasonable compensation for services rendered to Transportation by Dillier during the years 1956

and 1957 did not exceed $500 for each of those years (R. 238).

SPECIFICATION OF ERROR

It is petitioners' position that the Tax Court erred in determining that the principal purpose for the organization of the petitioner corporations was to avoid Federal income tax by securing the benefit of additional surtax exemptions which would not otherwise have been available. Further, it is petitioners' position that the finding of the Tax Court that the principal purpose for the organization of the petitioner corporations was to avoid Federal income tax by securing the benefit of additional surtax exemptions which would not otherwise have been available is contrary to the evidence of the case and the uncontradicted testimony of petitioners' witnesses.

It is also petitioners' position that the Tax Court erred in its determination of what was reasonable compensation for services rendered to Investment by its officers and employees during 1956 and further that the Tax Court erred in its determination of what was reasonable compensation for services rendered to Transportation by one of its officers during the years 1956 and 1957.

STATUTES AND REGULATIONS INVOLVED

All of the Statutes and Regulations cited herein are set forth in full in the Appendix hereto.

SUMMARY OF ARGUMENT

The uncontradicted facts and testimony of this case show that the principal purpose for the organization of the petitioner corporations was not to avoid Federal income tax by securing the benefit of additional surtax exemptions which would not otherwise have been available, but rather, that the controlling and principal purpose for their organization was to provide a flexible financial and corporate arrangement to aid in providing a large amount of funds for the current and retirement needs of the five major stockholders and to provide funds and/or income for the latters' heirs in case of a death. For the foregoing cash funds, of over $1,000,000, to be realized and distributed to the shareholders it took until 1964, but the pre-incorporation business reasons were there, they were acted upon in good faith and they did materialize. In addition to the foregoing principal business reasons for the organization of petitioner corporations there were other business reasons which the incorporators held in good faith. Most of those subsidiary business reasons also were realized.

The compensation paid by petitioners Transportation and Investment in 1956 and 1957 and disallowed by the Tax Court were paid under compensation arrangements entered into by unrelated parties, in

good faith, and based upon their best estimate of the situation at the time of making the compensation contracts. The compensation disallowed was not a disguised dividend nor was it paid for any other reason (nor did the Commissioner so claim), but to compensate the persons involved for services rendered during the applicable years. The compensation thus paid should be allowed as a tax deduction to Transportation and Investment for the years involved.

ARGUMENT

In imposing the surtax on the taxable income of a corporation, Section 11(c) of the Code provides an exemption of $25,000. In Section 269(a), it is provided that if a person or persons acquire control of a corporation and the principal purpose of such acquisition is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the deduction, credit, or allowance shall not be allowed. For the purposes of Section 269(a)(1), control is defined as the ownership of stock possessing at least fifty per cent of the total combined voting power of all classes of stock entitled to vote.

Acquisition of control, as used in Section 269, includes the formation of new corporations. *James Realty Co. v. United States,* 280 F. 2d 394; *Kessmar Construction Co.,* 39 T.C. 778.

Petitioners cite the case of *Bonneville Locks Towing Co., Inc., et al., v. United States,* D.C.W.D.W.,

1963, 63-2 U.S.T.C. 9782, at 90,094, giving illustrations, examples and a definition of the phrase "principal purpose" of Section 269 of the Internal Revenue Code of 1954:

> "The jury may consider the importance of a 'purpose' even though that purpose was a personal reason of the stockholder of the corporations.
>
> Evidence concerning a plan of the stockholders of the plaintiffs legally to reduce the estate taxes, which would come due upon their deaths, may be considered by the jury. A 'purpose' to minimize estate taxes is in no way connected with a 'purpose' to minimize corporate income taxes by securing a credit it would not otherwise enjoy.
>
> The phrase 'principal purpose' does not mean that the formation of a corporation must have been motivated solely for the reason of acquiring an additional surtax exemption. All that is required is that the purpose of acquiring an additional surtax exemption outranked or exceeded in importance other business reasons for the formation of the corporation.
>
> As a general proposition a taxpayer has a right to separate various phases of his business into separate entities and to combine them as he sees fit and has no obligation to adopt a course which carries a greater tax burden. However, if the principal purpose of a taxpayer in reorganizing his business into separate corporate divisions is to avoid or reduce federal tax liability, under the law the taxpayer may not claim or have the benefit of such avoidance or reduction of tax liability.

> The prohibited purpose of tax evasion or avoidance must be the 'principal' purpose of the taxpayer in reorganizing his business into separate corporations. However, mere consideration of tax consequences in such a reorganization in itself does not necessarily render it a principal purpose of the taxpayer."
>
> "The prohibition imposed by law is the acquiring control of a corporation if that acquisition is for the principal purpose of evasion or avoidance of Federal income tax. The principal purpose of the acquisition does not become evasion or avoidance merely because tax consequences were considered." *Security Homes, Inc., et al. v. United States,* D.C. N.D., 1963, 63-1 U.S.T.C. 9297, at 87,730.

In order for Section 269 to apply, the purpose to evade or avoid income tax must have been the principal purpose for the formation of the petitioner corporations here involved. The following quotation from *Mertens,* 7A Section 42.228 cited with approval by the Ninth Circuit Court of Appeals, in *Hawaiian Trust Company, Ltd. v. United States,* 291 F. 2d 768, makes the point clearly:

> "The prohibited purpose of tax evasion must be the 'principal' purpose, and the principal purpose of a transaction does not become tax evasion merely because its tax consequences are considered by the parties to the transaction."

The Regulations Section 1.269-3(a) provides that tax evasion or avoidance purposes must be the principal purpose for establishing a corporation and that

the tax avoidance purposes must exceed in importance any other purpose.

The Tax Court found and so stated:

> "We are convinced, from our study of the record, that the alleged business objectives did not in fact motivate the organization of the multiple corporations. The one purpose of apparent substance was the obtaining of the additional surtax exemptions of which Johnson had cognizance." (R. 253).

Petitioners submit that the uncontradicted evidence of the case shows that prior to Johnson becoming aware of the tax consequences he had generally decided upon the four corporations subject to further checking to see if there were any substantial reasons against going ahead with such a plan. At Tr. 29 Johnson stated "In the spring of 1954, I had about come to the conclusion that the only thing for us to do was to form a corporation, for a variety of reasons, and that the best arrangement would be to divide the organization into four corporations, and I discussed this with Mr. Madland, and he advised me that he thought it was an excellent plan and that it would enhance the lending ability of the bank and we would still have available to us bank financing funds."

Mr. Madland was the President of the Capitol National Bank of Sacramento. At the time of the trial he was retired and an unbiased witness. His testimony was uncontradicted. His testimony is set out below in full because of its importance concerning the intent with which petitioners were created (Tr. 264-268):

"Direct Examination

By Mr. Hea:

Q. Mr. Madland, when did you first become acquainted with the Made Rite Sausage Company partnership?

A. 1947.

Q. When did you first become acquainted with Mr. Thores Johnson?

A. About the same time.

Q. In what connection did you become acquainted with both the Made Rite Sausage Company and Mr. Thores Johnson?

A. I handled the banking business.

Q. Were you in the banking business at that time?

A. I was.

Q. What position did you hold?

A. I was President of the Capitol National Bank of Sacramento.

Q. Have you been in the banking business a long time?

A. Well, about fifty years.

Q. Mr. Madland, did you have occasion to talk to Mr. Thores Johnson in 1955 at all?

A. Yes, I did.

Q. About when?

A. Well, it's pretty hard to pin an exact time down at this late date. It was early in 1955.

Q. Do you recall the purpose of that meeting?

A. Yes, he wanted to keep me abreast of what was going on and he laid his story of proposed incorporation before me and wanted to know what we thought of it.

Q. What type of plan did he lay before you, roughly?

A. Well, again it is hard to get into specific detail, but he proposed four corporations. The purpose of them was to insure continuity of the business in the event of the passing of one of the partners, and then there was the partners' indebtedness that we wanted to take care of.

Q. Did you ever approve this idea?

A. It seemed to me that in view of all the circumstances surrounding the case, it was the only practical answer to it.

Q. On or about August 9, 1955, did you write a memo to your head office in regard to these incorporations?

A. I probably wrote more than one, but I am sure that on or about that time I did in answer to an inquiry from them.

Mr. Hea: No further questions, Your Honor.

Cross-Examination

By Mr. Moore:

Q. Mr. Madland, do you recall having made a statement to Mr. Johnson that the formation of four corporations would make it easier to borrow money?

A. No, I don't recall that I said that specifically.

Q. But substantially did you say that in substance?

A. How can I tell that seven years later? I told him that I thought his plan was one that would work.

Q. What was his plan?

A. His plan was four separate corporations and the purpose of the plan was to set it up so that they could get money out of it to pay the partners' indebtedness and to insure perpetuity of the business, and it was a good business.

Q. Do you remember any details of the plan submitted to you?

A. No, I don't remember the details of it except they were borrowing on the real estate; they were borrowing on the chattels.

Q. When the plan was put up to you did it call for them to form a relatively thin corporation, with a little stock and a lot of notes to the partners?

A. No, I don't remember that it did that specifically; the capital was adequate.

Q. Did the plan include restricted stock agreements limiting the sales of stock?

A. That I don't remember.

Q. In other words, you really don't remember the details of the plan?

A. I couldn't be sure—I shouldn't be expected to either.

Q. Is there any particular reason to recollect that you talked to Mr. Johnson about these four corporations?

A. There is every reason I should remember that because that's what there were—four corporations, four.

Q. And was there any reason that you can recall why four corporations would serve functions better than one?

A. The only thing I remember is that they wanted to set up several corporations so that in the event they wanted to sell any segment of the business they would have it set up so they could.

Q. I see.

A. The plan, so you will understand it, was to allow free sale of one corporation without being required to sell part of the others. What they wanted to do was preserve the Made Rite Sausage

business as such. Now, there was nothing specific laid down as to which corporation they wanted to sell. They did mention, as I recall, a possibility of selling the real estate and leasing it back, and also the trucking end of the business. That much I do remember.

Q. Selling it to third parties?

A. Yes. Outside of the business.

Mr. Moore: No further questions, Your Honor.

Mr. Hea: No further questions.

The Court: You are excused.

(Witness excused.)"

The matter of the tax implications of the four corporations versus one was taken into consideration in the same manner as any other aspect of the incorporation. Taxes were not considered a significant factor nor a decisive factor in the decision to incorporate the petitioners. The testimony of Johnson which the Tax Court relied on so heavily in its decision is set forth following (Tr. 201-203):

Cross-Examination
(of Mr. Johnson)

By respondent's counsel:

"Q. Mr. Johnson, you knew when these corporations were formed that there might be a tax advantage in forming four corporations rather than one; didn't you?

A. I knew that there were advantages in surtax exemptions. I didn't know whether they would be beneficial in this case.

Q. You knew you could gain further exemptions?

A. We thought we might; however, to offset that possibility there were increased expenses.

Q. But you did know that as far as your tax structure was concerned, additional exemptions would be allowable?

A. As far as the net income to us was concerned, we didn't think that it would make any difference.

Q. I am not talking about the net income to you. I am talking about the tax burden of the corporation business. You knew that the corporation business would get extra deductions if four corporations were formed rather than one?

A. That is right.

Q. And you took that into consideration in forming four corporations?

A. No. I think you take tax into consideration as you would any other matter.

Q. There was a significance?

A. No; this was not a decisive factor. It didn't seem to make a difference one way or another. We had no assurance that these corporations were going to make an income over $25,000 a year; in fact, some of them have lost money over the years.

Q. But you knew that the prior earnings of the business were such that the total would likely exceed $100,000?

A. We hoped so, or we would have gone broke very soon.

Q. Well, the prior earnings of the partnership, prior to 1955, indicated that each succeeding year had exceeded the previous year?

A. Yes.

Q. And you knew that?

A. Yes."

To further point up the fact that the surtax exemptions were not a decisive or a major factor in the decision to incorporate petitioners the uncontradicted testimony of the independent licensed public accountant, William Himmelmann who testified on cross-examination (Tr. 321 and 322), should be noted:

"By Mr. Moore:

Q. Mr. Himmelmann, how long have you been a member of the California Society of Public Accountants?

A. Let's say since 1950.

Q. Is that organization under state statute in California?

A. No, sir, it is not—You said the Society of California?

Q. Yes.

A. No, sir, it isn't.

Q. Didn't you discuss with the Made Rite owners the tax advantages of multiple corporations?

A. In that instance, Mr. Johnson called me in and asked me.

Q. You told him he could get extra exemptions if the corporations were recognized?

A. No, sir.

Q. You didn't?

A. I never told him he could get additional exemptions.

Q. You didn't?

A. No, sir."

From the foregoing testimony and that which appears at Tr. 47 and 48 (which will be set forth below verbatim) it is apparent that Thores Johnson merely discussed the idea of the four corporations with his

accountant, who prepared the partnership's tax return, in the same general manner as he had with his banker and insurance man and not with the idea of seeking out some prohibited tax-saving scheme:

"By Mr. Hea:

Q. After you talked to your banker in the early spring of 1955, did you talk to anyone else?

A. Well, of course we discussed it with our outside public accountant.

Q. What was his name?

A. William Himmelmann.

Q. After you discussed it with Mr. Himmelmann, did you discuss the idea of the four corporations or several corporations with anyone else that you can name?

A. Well, it is rather difficult to go back for five or six years, but I do know I discussed it with an insurance man.

Q. What was the insurance man's name?

A. Gilbert Schwarz.

Q. What time in 1955 did you make up your mind to go—strike that.

What action in '55 did you take to implement these four corporations?

A. We made our decision to set up these corporations, and then I told our accountant to get an attorney who would be competent to establish these corporations and this was in about mid-June of 1955.

Q. Did your accountant contact someone?

A. Yes, he contacted an attorney in San Francisco.

Q. Prior to this contact with this attorney in June and—I mean the middle of June, 1955, had you ever consulted with that attorney in regard to the four corporations?

A. I never met the attorney or knew him until he came into our office with Mr. Himmelmann, when we met to set up these organizations in late June.

The Court: June of what year?

The Witness: 1955."

Petitioners respectfully submit that business reasons prompted their incorporation and that in checking out the feasibility of creating four corporations Thores Johnson actually did less tax investigation than the taxpayers in *Bush Hog Manufacturing Co. Inc., et al.*, 42 T.C. No. 52 (1964). In *Bush Hog Manufacturing Co. Inc., et al.*, supra, the Tax Court said at page 42-529 (42.52 P-H T.C.):

"The only evidence that tax avoidance was a purpose in forming the separate corporations is the evidence that the principal officers consulted their banker, their lawyer, and their tax adviser before proceeding with the formation of the new corporations and were advised of the possible tax benefits, and the fact that the overall tax of the nine petitioners was actually reduced by the additional surtax exemptions. However, the tax adviser confirmed the testimony of the officers that when they consulted him they had already tentatively decided to form the additional corporations. He advised them that there might be tax disadvantages as well as benefits. There is no indication that he was asked to arrange or rearrange the program in a manner that would take best advantage of the tax benefits, nor is there any indication that he suggested forming separate corporations to the officers for the tax advantages to be gained."

The Tax Court stated at page 42 of its opinion (R. 249), that

> "Johnson recited a number of alleged business purposes which he claimed motivated the organization of multiple corporations. Although some of the reasons advanced were unclear, the principal ones appear to be as follows: (1) that problems potentially arising from the death of a stockholder would be reduced; (2) that labor problems would be minimized; (3) that more accurate accounting figures for each function of the business would be obtained; (4) that limited liability would be obtained for each corporation; (5) that the adoption of profit-sharing or incentive plans would be facilitated; (6) that unequal cash withdrawals by the partners would be eliminated; and (7) that the discounting of secured notes issued to the stockholders could provide funds to pay off certain personal obligations of the stockholders.
>
> An examination of the alleged business purposes reveals their lack of substance."

Petitioners respectfully submit that the Tax Court erred in its conclusion and finding that "an examination of the alleged business purposes reveals their lack of substance". Petitioners further submit that this is not a mere factual determination made by the Tax Court based upon inferences drawn by said Court from the evidence, but rather is a determination which is clearly erroneous and thus the subject matter for correction by this Court. *Kessmar Construction Co. v. Comm.*, 336 F. 2d 865, 14 AFTR 2d 5597. Petitioners submit that a review of the entire evidence of this case will leave this Court with a definite and firm con-

viction that a mistake has been committed in the Tax Court's holding in regard to the multiple surtax issue of this case. *United States v. U. S. Gypsum Company*, 1948, 333 U.S. 364. In support of the foregoing statement petitioners analyze the evidence of the case as they see it.

In analyzing the testimony of Thores Johnson petitioners would like to first call attention to his educational training and experience background, which is summarized as follows:

Thores Johnson, who was in charge of the accounting was first employed by the Made Rite Sausage Co. (a co-partnership) in the year 1930. At that time he was 24 years of age (Tr. 20). At the time of his employment by the partnership, he had had no corporate accounting experience. He was hired initially as a bookkeeper. He later became office manager and then later, in 1942, acquired a partnership interest (Tr. 21). It can be seen from the foregoing that Thores Johnson had had no corporate accounting or tax training or experience which would enable him to answer in *words of art*, questions put to him as a witness at the Tax Court hearing. His answers were those of a layman, not those of a skilled tax practitioner.

The Tax Court in analyzing and explaining its interpretation of the evidence of the case first concluded,

> "According to Johnson, it had been felt that, in the event of the death of a stockholder, his heirs might be persuaded to retain the stock of the corporations holding the real estate and trucks.

The benefit of this arrangement to the business would apparently be that if the heirs so decided, it would be necessary to raise cash only to acquire the decedent's stock in the sales and manufacturing companies. The purported intention to hold the real estate and trucks for this purpose is not supported by the facts, however, which show that the trucks were sold and leased back and that efforts were made by the petitioners to do the same with the real estate. No reason was given as to why the stock of separate corporations holding the real estate and trucks would be more attractive to the heirs than the stock of a single corporation conducting the entire business, except to say that the two corporations would have 'fixed income'. However, the record shows that no dividends were paid by either Investment or Transportation during the taxable years. The record further shows that the trucks provided no income except through their use in the meat packing business, which the petitioners maintain was speculative, and that the real estate did not provide a significant amount of outside income. If the heirs did not wish to retain their stock in these two corporations, Johnson testified, the real estate or trucks could be sold to raise cash to pay the heirs. No explanation is given as to why the real estate or trucks, if held in a single corporation, could not as readily have been sold to raise the needed cash." (R. 249).

In analyzing the foregoing interpretation by the Tax Court petitioners would like to first take up the matter of the death or *retirement* of a partner. In Johnson's testimony he stated that prior to incorpora-

tion they (the partners) were concerned both with the *retirement* and/or the death of a partner—not just the death and the heir problem as the Tax Court concluded (Tr. 27). In March 1954, long before incorporation, Johnson was trying to make a sale and leaseback of the $1,000,000 plant property so as to "realize a capital fund" (Tr. 27). None of the five partners had died at this time so it is obvious that the capital fund was to provide for paying off Dillier and for retirement funds for the partners (Tr. 29). If the sale and leaseback had been made in March, 1954, the $1,000,000 of funds would have become the property of the partners to ease their financial burdens and to release substantial funds to the partners, as the four partners other than Dillier were very concerned by the fact that almost their entire lifetime asset accumulations (Tr. 32) were locked into this large but *very local* business enterprise, which enterprise employed approximately 200 employees with annual sales of around $7,000,000 and assets of better than $2,000,000 (Tr. 21). From Johnson's testimony it can be seen that there were two desired business results they wanted to obtain by keeping the real estate separate, one, creating a large capital fund from the sale and leaseback, and if a sale and leaseback were not available, then from the rental of the property a fixed income available to the partners or their heirs (Tr. 27 and 30). In 1964 Made Rite Investment Co. finally was able to arrange and complete a sale of its large plant property, liquidate and distribute to its stockholders (only one of whom had died in the mean-

time), this large capital fund, without having to pay a double tax on the sale as would have been the tax result if the plant property had been in one large corporation, had been sold therein, and an attempt made to distribute the proceeds to the living stockholders. In the latter event Section 337 of the Internal Revenue Code of 1954 would not have been available to eliminate the double tax, i.e., a capital gains tax at the corporate level and an ordinary dividend tax upon the distribution of the funds, or at the very least a second capital gains tax on the distributed funds if the individual shareholders could have met the provisions of Section 302 of the Internal Revenue Code of 1954.

It is submitted that the foregoing constitutes a proper business purpose as Section 269 of the Internal Revenue Code of 1954 was not designed to prohibit such planning. Section 269 concerns itself with the situation where

> "principal purpose . . . is evasion or avoidance of Federal income tax by securing the benefit of a *deduction, credit or other allowance* which such person or corporation would not otherwise enjoy . . ."

Petitioners submit that the arranging of one's business affairs in order to provide financial flexibility such as petitioners' organizers had in mind and as detailed hereinbefore is not proscribed by Section 269 as the Tax Court's opinion in effect held. *Bonneville Locks Towing Co., Inc., et al. v. U. S.*, supra.

The law on the subject of a taxpayer's right and limitations to mold his business and personal financial arrangements is well stated in *Aldon Homes, Inc.*, 33 T.C. 582 and appearing at page 596:

> "It is axiomatic that taxpayers have the right to mold business transactions in such a manner as to minimize the incidence of taxation, for no taxpayer is obligated to pay more tax than the law demands of him. *United States v. Isham*, 84 U.S. 496; *Gregory v. Helvering*, 293 U.S. 465; *United States v. Cumberland Public Service Co.*, 338 U.S. 451.
>
> In *Higgins v. Smith*, 308 U.S. 473, the Supreme Court, although recognizing that '(a) taxpayer is free to adopt such organization for his affairs as he may choose,' nevertheless stated:
>
> On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property.
>
> In *National Investors Corp. v. Hoey* (C.A. 2) 144 F.2d 466, 468, Judge Learned Hand pointed out that: to be a separate jural person for purposes of taxation, a corporation must engage in

some industrial, commercial, or other activity besides avoiding taxation: in other words, that the term 'corporation' will be interpreted to mean a corporation which does some 'business' in the ordinary meaning; and that escaping taxation is not 'business' in the ordinary meaning.

In *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334, the Supreme Court stated: The incidence of taxation depends upon the substance of a transaction. * * * To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

As was earlier stated by the Supreme Court in *Gregory v. Helvering,* supra, 'To hold otherwise would be to exalt artifice above reality, and to deprive the statutory provisions in question of all serious purpose.'

The above cases make it clear that a taxpayer may adopt any form he desires for the conduct of his business and that form cannot be ignored merely because it results in a tax saving. However, to be afforded recognition the form the taxpayer chooses must be a viable business entity, that is, it must have been formed for a substantial business purpose or actually engage in substantive business activity. *Moline Properties, Inc. v. Commissioner,* 319 U.S. 436; *Jackson v. Commissioner,* (C.A. 2, 1956) 233 F. 2d 289. Escaping taxation is not a substantive business activity. *National Carbide Corp. v. Commissioner,* 336 U.S. 422, footnote 20, citing *National Investors Corp. v. Hoey,* supra."

From a reading of the foregoing case material, it can be seen that taxpayers have the right to create one or more corporations so long as the corporations are formed for a substantial business purpose and actually engage in substantive business activity. As regards Made Rite Investment Co., real property of a value of at least $1,000,000 was placed in the corporation. A court can take judicial notice of the fact that thousands upon thousands of real property rental corporations have been created in the United States with considerably less by way of assets and considerably less by way of rental income. A court can also take judicial notice of the fact that these same thousands upon thousands of real property rental corporations have been allowed their surtax exemptions by the Internal Revenue Service where the business reasons for their incorporation were less than in the case of petitioner, Made Rite Investment Co. This petitioner should not be penalized because incident to its incorporation for justified business purposes a surtax exemption became available to it and thus a tax savings. *Maxwell Hardware Co. v. Comm.*, decided March 30, 1965, 65-1 U.S.T.C. 9332, 9th Cir. The business reasons for incorporating petitioner, Made Rite Investment Co., far outweighed any tax-savings reasons proscribed by Section 269, therefore, the Tax Court's disallowance of the surtax exemption of this petitioner, for the tax years involved in this petition should be reversed.

The same evidence, reasoning and law which has been set forth in the foregoing in regard to the busi-

ness reasons for the creation of petitioner, Made Rite Investment Co., are equally applicable to Made Rite Transportation Co.; as is said evidence, reasoning and law, justification and authority for this Court to reverse the Tax Court's decision disallowing the surtax exemptions of this petitioner, Made Rite Transportation Co., for the tax years here involved in its case. The value of the trucks transferred to this corporation exceeded $250,000. When a sale and leaseback of the trucks was found feasible, as planned these funds were distributed to the incorporators, upon the liquidation of Made Rite Transportation Co. (Tr. 189).

The same evidence, reasoning and law which has been set forth in the foregoing in regard to the business reasons for the creation of petitioner, Made Rite Investment Co., are equally applicable to Made Rite Manufacturing Co.; as is said evidence, reasoning and law, justification and authority for this Court to reverse the Tax Court's decision disallowing the surtax exemptions of this petitioner, Made Rite Manufacturing Co., for the tax years here involved in its case. The value of the meat manufacturing equipment transferred to this corporation was of an approximate value of $750,000. From its corporate inception it employed nearly 200 employees (Tr. 21). It is submitted that this corporation certainly constitutes a viable corporation serving a truly business purpose as set forth in *National Investors Corp. v. Hoey*, (C.A. 2) 144 F. 2d 466, 468, and Judge Learned Hand pointed out that: "to be a separate jural person for purposes of taxation, a corporation must engage

in some industrial, commercial, or other activity besides avoiding taxation: in other words, that the term 'corporation' will be interpreted to mean a corporation which does some 'business' in the ordinary meaning." As Thores Johnson testified it is not uncommon in the meat industry for a manufacturer not to directly sell its products at retail and it is also not uncommon for there to be meat sales organizations which do not manufacture the products they sell (Tr. 39, 40 and 42).

As Johnson testified there were a number of other minor business objectives and factors which he felt influenced him and his associates to settle on four corporations rather than one. He discussed them briefly in his testimony (Tr. 33 to 47, inclusive). The Tax Court in its opinion treats these additional objectives and factors as major business reasons, and since a number of them had not materialized at the time of trial or had not resulted in immediate benefit to the petitioners, the Tax Court held that an examination of the alleged business purposes reveals their lack of substance (R. 249). Petitioners respectfully submit that the Tax Court is in error in so holding. The primary business purpose of the four corporations was to provide financial flexibility in providing for the retirement or death of one or more of the five original partners. This was accomplished as explained previously in this brief. The other benefits hoped to be gained were merely incidental. It must be remembered that Johnson, with his limited corporate experience and limited educational background was during the pre-incorporation period asking his associates in the

meat packing industry about corporations. It is obvious that he would be presented with many ideas by his business associates that may or may not have applicability to his firm's own situation. Johnson in good faith believed that the desired results would flow from the four corporations. A court can take judicial notice of the fact that many lay people think there is great business magic in a corporation and obviously if one corporation would give those business benefits, four should give more business benefits. It is submitted that the petitioners should not be penalized because all their business hopes and plans did not immediately materialize. It is well recognized law that a court should be reluctant to substitute its business judgment for that of the business man who is on the firing line, especially where the business man has a very limited technical and experience background and the problem to be solved is one requiring technical knowledge and experience.

The Tax Court listed seven reasons which it states were advanced by Johnson as "principal" reasons (R. 249), as follows:

(1) That problems potentially arising from the death of a stockholder would be reduced; (2) that labor problems would be minimized; (3) that more accurate accounting figures for each function of the business would be obtained; (4) that limited liability would be obtained for each corporation; (5) that the adoption of profit-sharing or incentive plans would be facilitated; (6) that unequal cash withdrawals by the partners would be eliminated; and (7) that the dis-

counting of secured notes issued to the stockholders could provide funds to pay off certain personal obligations of the stockholders.

Petitioners submit that only the first was a material business reason and that this has been accomplished as explained previously herein. Further, number seven is only a part of the other major objective, namely, providing financial means for retirement of one or more of the partners. This retirement objective, a major objective, the Tax Court has completely overlooked. The note arrangement was merely a source of funds to pay off the personal obligations owed to Dillier by the remaining four partners. The sale and leaseback of the major assets, land, building and refrigerated trucks was to provide substantial funds for all five partners and before death, as well as after death. These sales and leasebacks have been accomplished, resulting in a distribution for retirement purposes of approximately $1,000,000 to the five incorporation shareholders.

It is submitted that as to item two Johnson honestly felt his labor position would be improved and that this is all that the law requires. A major labor catastrophe is not necessary to prove him right.

Petitioners submit that more accurate accounting figures have resulted between different functions under the control of different partners. See the differences in net profits of the various petitions (R. 235). To the lay mind separate corporations require separate accounting much, much more than would mere divisions of the same corporation. It should be remembered that it was the intention of the partners before incor-

poration that four of the five partners would each handle the activities of a separate corporation, i.e., one partner to one corporation. The fact that later experience taught them that this was not practicable should not be held against them under the tax laws. Further, the fact that it took a year or so for Johnson and the licensed public accountant (not Certified Public Accountant), to work out all the correct detailed accounting procedures should be viewed as a favorable matter on this score as it shows good faith. As they found better and more accurate accounting methods they adopted them. After the first two years of operation of petitioners, the Commissioner does not take exception to any of their accounting procedures.

Limited liability has been obtained for each corporation as to the general public even though as to the bank the latter insisted on cross-guarantees between petitioners for loans. Such bank practice is standard in California. The incorporators were able to split up some two million of assets into four separate corporations, each corporation's assets being protected from the general liabilities of the other corporation. The advanced age of these men should be remembered for at that age they would not be willing to start over but would be much more willing to salvage what they could in the event of a serious financial reverse regardless of what it might do to their long-run financial reputation—as they at that point would be retiring from active business anyway.

As to item four, the petitioners engaged an expert in 1956 (Tr. 47), to study the feasibility of any of the four corporations adopting a qualified profit-sharing

plan or qualified pension plan at that time. The expert recommended against the adoption of either a qualified profit-sharing plan or a qualified pension plan by any of the corporations. Here again petitioners should not be penalized because upon qualified advice they did not proceed. Further, before incorporation they knew as partners they could not participate in such plans (Tr. 47), and that it would only be in corporate form that they would have a chance to participate in a qualified profit-sharing or a qualified pension plan.

Unequal cash withdrawals were eliminated. All the incorporators were on fixed salaries, thus this reason did produce results (R. 234).

Item seven has previously been discussed and it did achieve its objective.

In conclusion, as to the multiple surtax issue, if the principal purpose for organizing petitioners was to obtain additional surtax exemptions, why would the shareholders voluntarily have given up three of the four surtax exemptions since petitioners were incorporated, as follows:

1. Made Rite Sausage Co.—voluntarily given up in 1958 when Sausage elected to report its income from 1958 on as a small business corporation under Subchapter S of Chapter 1, Sections 1371 and 1372(a) to (d) of the Internal Revenue Code of 1954.

2. Made Rite Transportation Co.—this corporation was dissolved and its assets distributed in 1962.

3. Made Rite Investment Co.—this corporation was dissolved and its assets distributed in 1964.

As to the compensation issue or issues involved in this appeal petitioners are of the opinion that the case of *Fine Realty, Inc. v. U. S.,* 209 F. Supp. 286, 10 AFTR 2d 5751, is in point and we quote from that opinion at page 5754:

> "The first issue is as to the propriety of the deduction of $9,000.00 for Mrs. Fine's salary. The evidence in this regard is inconclusive. On the one hand, there was testimony by Mrs. Fine and by her husband that as president of Fine Realty, Inc., she performed valuable services for that corporation. On the other, there was testimony by employees of the taxpayer that Mrs. Fine did not perform any such services. There is evidence that Mrs. Fine did in fact perform some services for the Fine enterprises, considered collectively, although it is difficult to find that the services were for the exclusive benefit of the corporation which paid her. The Court is of the view, however, that in determining reasonableness of the salary involved it must look beyond the corporate entity, Fine Realty, Inc., to the entire structure of the Fine enterprises. This factor, along with the fact that the combined total salaries of Mr. and Mrs. Fine, as shown on their joint return for 1955, were $54,000.00 (not a patently excessive amount), leads the Court to conclude that the salary deduction was not unreasonable and was improperly disallowed."

Petitioners submit that for the years 1956 and 1957 the compensation paid to Dillier, Johnson, Geneva Hayhurst, Chester Brewster and M. Schoenbacker was fair and reasonable; for in the years 1958 and 1959,

the same, or greater amounts, were paid to these persons as compensation and were allowed upon audit by the Commissioner and not changed by the Tax Court when it was deciding the tax case below for those years. Petitioners respectfully urge that this Court reverse the compensation disallowances made by the Tax Court in regard to the foregoing people for the years 1956 and 1957 and allow to petitioners as a tax deduction under Section 162(a) of the Internal Revenue Code of 1954, all compensation paid to them by petitioners during the years 1956 and 1957, as a reasonable allowance for salaries or other compensation for personal services actually rendered in carrying on a trade or business.

CONCLUSION

Petitioners respectfully submit that the uncontradicted evidence and testimony shows that the Tax Court erred in its conclusion and finding that the principal purpose for the organization of petitioner corporations was tax avoidance. Petitioners further submit that this is not a mere factual determination made by the Tax Court based upon inferences drawn by said Court from the evidence, but rather is a determination which is clearly erroneous and thus the subject matter for correction by this Court. *Kessmar Construction Co. v. Comm.*, supra.

As to the compensation issue involved in this appeal petitioners urge that the case of *Fine Realty, Inc. v. U. S.* should control the disposition of said compensation issue.

In view of the above it is respectfully requested that the decisions of the Tax Court be reversed as to all petitioners.

Dated, San Francisco, California,
September 20, 1965.

Respectfully submitted,
WAYNE HEA,
HEA AND ANDERSON,
Attorneys for Petitioners.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with these rules.

WAYNE HEA,
Attorney for Petitioners.

(Appendix Follows)

Appendix.

Appendix

STATUTES AND REGULATION INVOLVED

Internal Revenue Code Section 162(a)(1):

Sec. 162. Trade or Business Expenses.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

Internal Revenue Code Section 269:

Sec. 269. Acquisitions Made to Evade or Avoid Income Tax.

(a) In General.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

(b) Power of Secretary or His Delegate to Allow Deduction, etc., in part.—In any case to which subsection (a) applies the Secretary or his delegate is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the

evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

(c) Presumption in Case of Disproportionate Purchase Price.—The fact that the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—

(1) of the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (1) of subsection (a)), or of the property acquired specified in paragraph (2) of subsection (a); and

(2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition,

shall be prima facie evidence of the principal purpose of evasion or avoidance of Federal income tax. This subsection shall apply only with respect to acquisitions after March 1, 1954.

Internal Revenue Code Section 302:

Sec. 302. Distributions in Redemption of Stock.

(a) General Rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b)

applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions Treated as Exchanges.—

(1) Redemptions Not Equivalent to Dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially Disproportionate Redemption of Stock.—

(A) In General.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) Limitation.—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) Definitions.—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all

of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) Series of Redemptions.—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) Termination of Shareholder's Interest.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) Stock Issued By Railroad Corporations in Certain Reorganizations.—Subsection (a) shall apply if the redemption is of stock issued by a railroad corporation (as defined in section 77(m) of the Bankruptcy Act, as amended) pursuant to a plan of reorganization under section 77 of the Bankruptcy Act.

(5) Application of Paragraphs.—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

(c) Constructive Ownership of Stock.—

(1) In General.—Except as provided in paragraph (2) of this subsection, section 318 (a) shall apply in determining the ownership of stock for purposes of this section.

(2) For Determining Termination of Interest.—

(A) In the case of a distribution described in subsection (b) (3), section 318 (a) (1) shall not apply if—

(i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,

(ii) the distributee does not acquire any such interest (other than stock acquired by

bequest or inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Secretary or his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

If the distributee acquires such an interest in the corporation (other than by bequest or inheritance) within 10 years from the date of the distribution, then the periods of limitation provided in sections 6501 and 6502 on the making of an assessment and the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting from such acquisition, include one year immediately following the date on which the distributee (in accordance with regulations prescribed by the Secretary or his delegate) notifies the Secretary or his delegate of such acquisition; and such assessment and collection may be made notwithstanding any provision of law or rule of law which otherwise would prevent such assessment and collection.

(B) Subparagraph (A) of this paragraph shall not apply if—

(i) any portion of the stock redeemed was acquired, directly or indirectly, within the

10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318 (a), or

(ii) any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318 (a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.

The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

(d) Redemptions Treated As Distributions of Property.—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317 (b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

(e) Cross References.—

For special rules relating to redemption—

(1) Death Taxes.—Of stock to pay death taxes, see section 303.

(2) Section 306 Stock.—Of section 306 stock, see section 306.

(3) Liquidations.—Of stock in partial or complete liquidation, see section 331.

Internal Revenue Code Section 337:

Sec. 337. Gain or Loss on Sales or Exchanges in Connection With Certain Liquidations.

(a) General Rule.—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

(b) Property Defined.—

(1) In General.—For purposes of subsection (a), the term "property" does not include—

(A) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,

(B) installment obligations acquired in respect of the sale or exchange (without regard to whether such sale or exchange occurred before, on, or after the date of the adoption of the plan referred to in subsection (a)) of stock in trade or other property described in subparagraph (A) of this paragraph, and

(C) installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.

(2) Nonrecognition with Respect to Inventory in Certain Cases.—Notwithstanding paragraph (1) of this subsection, if substantially all of the property described in subparagraph (A) of such paragraph (1) which is attributable to a trade or business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection (a) the term "property" includes—

(A) such property so sold or exchanged, and

(B) installment obligations acquired in respect of such sale or exchange.

(c) Limitations.—

(1) Collapsible Corporations and Liquidations to Which Section 333 Applies.—This section shall not apply to any sale or exchange—

(A) made by a collapsible corporation (as defined in section 341 (b)), or

(B) following the adoption of a plan of complete liquidation, if section 333 applies with respect to such liquidation.

(2) Liquidations to Which Section 332 Applies.—In the case of a sale or exchange following the adoption of a plan of complete liquidation, if section 332 applies with respect to such liquidation, then—

(A) if the basis of the property of the liquidating corporation in the hands of the distributee is determined under section 334 (b) (1), this section shall not apply; or

(B) if the basis of the property of the liquidating corporation in the hands of the distributee is determined under section 334 (b) (2), this section shall apply only to that portion (if any) of the gain which is not greater than the excess of (i) that portion of the adjusted basis (adjusted for any adjustment required under the second sentence of section 334 (b) (2) of the stock of the liquidating corporation which is allocable, under regulations prescribed by the Secretary or his delegate, to the property sold or exchanged, over (ii) the adjusted basis, in the hands of the liquidating corporation, of the property sold or exchanged.

(d) Special Rule For Certain Minority Shareholders.—If a corporation adopts a plan of complete liquidation on or after January 1, 1958, and if subsection (a) does not apply to sales or exchanges of

property by such corporation, solely by reason of the application of subsection (c) (2) (A), then for the first taxable year of any shareholder (other than a corporation which meets the 80 percent stock ownership requirement specified in section 332 (b) (1)) in which he receives a distribution in complete liquidation—

(1) the amount realized by such shareholder on the distribution shall be increased by his proportionate share of the amount by which the tax imposed by this subtitle on such corporation would have been reduced if subsection (c) (2) (A) had not been applicable, and

(2) for purposes of this title, such shareholder shall be deemed to have paid, on the last day prescribed by law for the payment of the tax imposed by this subtitle on such shareholder for such taxable year, an amount of tax equal to the amount of the increase described in paragraph (1).

Internal Revenue Code Section 1371:

Sec. 1371. Definitions.

(a) Small Business Corporation.—For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not—

(1) have more than 10 shareholders;

(2) have as a shareholder a person (other than an estate) who is not an individual;

(3) have a nonresident alien as a shareholder; and

(4) have more than one class of stock.

(b) Electing Small Business Corporation.—For purposes of this subchapter, the term "electing small business corporation" means, with respect to any taxable year, a small business corporation which has made an election under section 1372(a) which, under section 1372, is in effect for such taxable year.

(c) Stock Owned by Husband and Wife.—For purposes of subsection (a)(1) stock which—

(1) is community property of a husband and wife (or the income from which is community income) under the applicable community property law of a State, or

(2) is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common,

shall be treated as owned by one shareholder.

(d) Ownership of Certain Stock.—For purposes of subsection (a), a corporation shall not be considered a member of an affiliated group at any time during any taxable year by reason of the ownership of stock in another corporation if such other corporation—

(1) has not begun business at any time on or after the date of its incorporation and before the close of such taxable year, and

(2) does not have taxable income for the period included within such taxable year.

Internal Revenue Code Section 1372(a)(b)(c)(d):

Sec. 1372. Election By Small Business Corporation.

(a) Eligibility.—Except as provided in subsection (f), any small business corporation may elect, in accordance with the provisions of this section, not to be subject to the taxes imposed by this chapter. Such election shall be valid only if all persons who are shareholders in such corporation—

(1) on the first day of the first taxable year for which such election is effective, if such election is made on or before such first day, or

(2) on the day on which the election is made, if the election is made after such first day,

consent to such election.

(b) Effect.—If a small business corporation makes an election under subsection (a), then—

(1) with respect to the taxable years of the corporation for which such election is in effect, such corporation shall not be subject to the taxes imposed by this chapter and, with respect to such taxable years and all succeeding taxable years, the provisions of section 1377 shall apply to such corporation, and

(2) with respect to the taxable years of a shareholder of such corporation in which or with which the taxable years of the corporation for which such election is in effect end, the provisions of

sections 1373, 1374, and 1375 shall apply to such shareholder, and with respect to such taxable years and all succeeding taxable years, the provisions of section 1376 shall apply to such shareholder.

(c) Where and How Made.—

(1) In General.—An election under subsection (a) may be made by a small business corporation for any taxable year at any time during the first month of such taxable year, or at any time during the month preceding such first month. Such election shall be made in such manner as the Secretary or his delegate shall prescribe by regulations.

(2) Taxable Years Beginning Before Date of Enactment.—An election may be made under subsection (a) by a small business corporation for its first taxable year which begins after December 31, 1957, and on or before the date of the enactment of this subchapter, and ends after such date at any time—

(A) within the 90-day period beginning on the day after the date of the enactment of this subchapter, or

(B) if its taxable year ends within such 90-day period, before the close of such taxable year.

An election may be made pursuant to this paragraph only if the small business corporation has

been a small business corporation (as defined in section 1371(a)) on each day after the date of the enactment of this subchapter and before the day of such election.

(d) Years For Which Effective.—An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, unless it is terminated, with respect to any such taxable year, under subsection (e).

Income Tax Regulation § 1.269-3:

§ 1.269-3. Instances in which section 269(a) disallows a deduction, credit, or other allowance.

(a) Instances of disallowance. Section 269 specifies two instances in which a deduction, credit, or other allowance is to be disallowed. These instances, described in paragraphs (1) and (2) of section 269(a), are those in which—

(1) Any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) Any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation (not controlled, directly or indirectly, immediately before such acquisition by such acquiring corporation or its stockholders), the basis of which property in the hands of the acquiring corporation is determined by reference to the basis in the hands of the transferor corporation.

In either instance the principal purpose for which the acquisition was made must have been the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such other person, or persons, or corporation, would not otherwise enjoy. If this requirement is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought. Thus, an acquiring person or corporation can secure the benefit of a deduction, credit, or other allowance within the meaning of section 269 even though it is the acquired corporation that is entitled to such deduction, credit, or other allowance in the determination of its tax. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of section 269 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom. For the presumption of a principal purpose of tax evasion or avoidance, see section 269(c) and § 1.269.5.